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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1974

No. 74-742

FOREMOST-McKESSON, INC.,
Petitioner,

vs.

PROVIDENT SECURITIES COMPANY,
Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

RESPONDENT'S BRIEF

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Table of Contents

	Page
Statutes and Rules Involved	1
Questions Presented	2
Statement of the Case	3
A. The facts	3
1. Background	3
2. The purchase agreement	5
3. Provident's plan of liquidation	6
4. The debentures	7
5. The underwriting agreement and subsequent events	8
B. The proceedings below	9
Summary of Argument	10
Argument	12
I. The Court of Appeals correctly determined that § 16 (b) was inapplicable to the transaction because Provident had no ownership or other interest in Foremost at the time of the acquisition of the Foremost debentures	12
A. The express terms of § 16(b), the statute's purpose and its history demonstrate that § 16(b) applies to beneficial owners of securities who are, by virtue of their relationship to the issuer, in a position to abuse inside information both at the time of the purchase and of the sale	12
1. Under the terms of the statute, a beneficial owner must be such both at the time of the purchase and of the sale	12
2. No court other than the court below has examined the proviso here in question in light of its purpose and history	17
3. The purpose and the legislative history of § 16 (b) support the conclusion that it applies to beneficial owners of securities who are, by virtue of their ownership, in a position to abuse inside information at the time of the purchase	20

Pages

B. Foremost's arguments are founded upon misconceptions of the statute's purpose and history 25

II. The transaction was not subject to speculative abuse .. 32

A. The exchange of assets for debentures was an "unorthodox" transaction 33

B. The transaction involved no potential for speculative abuse 37

1. Provident did not have, and was not likely to have, access to inside information or any control or influence over Foremost 37

2. The court below erred in its conjecture that there was a potential for speculative abuse ... 42

C. The application of § 16(b)'s conclusive presumption to the facts of this case would raise serious constitutional questions 45

III. Provident's sale of the debentures occurred when it was not an owner, directly or indirectly, of 10% or more of Foremost's common stock 49

IV. The transaction was exempt from § 16(b) because Provident acted at all pertinent times on behalf of its shareholders 52

A. Provident was a liquidating agent authorized by California law to administer the assets of its shareholders 52

B. Provident did not have beneficial ownership of the debentures at the time of the purchase and the sale 57

1. Beneficial ownership at all times rested in Provident's shareholders, not in Provident itself .. 57

2. In any event, Provident was not a beneficial owner of 10% or more of a class of Foremost's securities at the time of sale 59

Conclusion 61

Appendix ..... i-x

Table of Authorities

Cases

Pages

Adler v. Klawans, 267 F.2d 840 20

Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc., 372 F.Supp. 570 .....18, 39

American Standard, Inc. v. Crane Co., 510 F.2d 1043 .....31, 44

Bershad v. McDonough, 428 F.2d 693 50

Blau v. Lamb, 363 F.2d 507 .....22, 36, 45

Blau v. Lehman, 368 U.S. 403 16

Blau v. Lehman, 286 F.2d 786 35

Champion Home Builders Co. v. Jeffress, 490 F.2d 611 50

Chemical Fund, Inc. v. Xerox Corporation, 377 F.2d 107 .....34, 40, 47

Emerson Electric Co. v. Reliance Electric Company, 434 F.2d 918 18

Feder v. Martin Marietta Corporation, 406 F.2d 260 20

Ferraiolo v. Newman, 259 F.2d 342 37

Gratz v. Claughton, 187 F.2d 46 46

Kern County Land Co. v. Occidental Corp., 411 U.S. 582 ...3, 11, 13-14, 22, 29, 30, 32, 33, 34, 36, 37, 38, 43, 44, 45, 46, 51, 52

Langnes v. Green, 282 U.S. 531 32

Makofsky v. Ultra Dynamics Corporation, 383 F.Supp. 631 .. 41

Meyers v. El Tejon Oil & Refining Co., 29 Cal.2d 184, 174 P.2d 1 59

Newmark v. RKO General, Inc., 425 F.2d 348 .....13, 18

Park & Tilford v. Schulte, 160 F.2d 984 46

Perine v. William Norton & Company, Inc., 509 F.2d 114 .. 18

Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418 .....12, 18, 28, 29, 37, 46

Simon v. Sunasco, CCH Fed.Sec.L.Rep., ¶ 92,547, p. 98,509 .. 41

Smith v. Taecker, 133 Cal.App. 351, 24 P.2d 182 59

Smolowe v. Delendo Corporation, 136 F.2d 231 .....22, 46, 47

Stella v. Graham-Paige Motors Corp., 104 F.Supp. 957 17

Stella v. Graham-Paige Motors Corporation, 232 F.2d 299 .. 17

Stelos Co. v. Hosiery Corp., 295 U.S. 237 32

Pages

Vlandis v. Kline, 412 U.S. 441 48

Western Auto Supply Company v. Gamble-Skogmo, Inc., 348 F.2d 736 22

Constitutions

United States Constitution:
5th Amendment 46, 48

Federal Statutes

48 Stat. 881, 15 U.S.C. § 78a 1

48 Stat. 891, 15 U.S.C. § 78j(b) 31

48 Stat. 896, 15 U.S.C. § 78p(b) 46, 52-53, 57, 59

78 Stat. 579, 15 U.S.C. §78p(d) 1, 26

Securities Exchange Act of 1934:
Section 3(a)(11), 15 U.S.C. § 78c(a)(11) 1, 40, 47
Section 3(a)(14), 15 U.S.C. § 78c(a)(14) 1, 49
Section 10(b), 15 U.S.C. § 78j(b) 1, 31, 48
Section 16, 15 U.S.C. § 78p 1, 28
Section 16(b), 15 U.S.C. § 78p(b) .....passim
Section 16(d), 15 U.S.C. § 78p(d) 26, 27
Section 16(e), 15 U.S.C. § 78p(e) 27

State Statutes

California Corporations Code:
Section 3003 ..... 1, 44
Section 4600 ..... 1, 54
Section 4603 ..... 1, 54
Section 4604 ..... 1, 54
Section 4605 .....1, 54, 56, 58
Section 4606 .....1, 56, 60
Section 4607 ..... 1, 56
Section 5000 .....1, 54, 56, 58

Regulations

17 C.F.R. § 240.10b-5 .....1, 31, 48

17 C.F.R. § 240.16a-4 .....1, 3, 11, 53, 55, 56, 57

17 C.F.R. § 240.16b-2 ..... 1, 27

Law Review Articles and Texts

Pages

Cole, Insiders' Liabilities under the Securities Exchange Act of 1934 (1958) 12 Southwestern L.R. 147 19

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Loss, Securities Regulation (2d Ed. 1969) Vol. II 35

Loss, Securities Regulation (Supp.2d Ed. 1969) Vol. V 35, 58

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Painter, Federal Regulation of Insider Trading (1968) 18, 19

Seligman, Problems under the Securities Exchange Act (1934) 21 Va.L.Rev. 1 .....15, 16

Other Authorities

Congressional Record (1934) 73rd Cong., pp. 8036-8038 23

Congressional Record (1964) 88th Cong., 2nd Sess., pp. 17921, 17926-17929, 18181, 18182-18183 26

Hearings on H.R. 7852 and H.R. 8720, House Comm. on Interstate and Foreign Commerce, 73rd Cong. (1934) 21, 48

Hearings on S.Res. 84, S.Res. 56 and S.Res. 97, Senate Comm. on Banking and Currency, 73rd Cong. (1934) 13, 22, 23, 24, 25

House Report No. 1838 (1934) 73rd Cong. 23

Senate Report No. 379 (1963) 88th Cong., 1st Sess. 26

Senate Report No. 792 (1934) 73rd Cong., 2d Sess. 46

Senate Report No. 1455 (1934) 73rd Cong., 2d Sess. 27-28

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RESPONDENT'S BRIEF

STATUTES AND RULES INVOLVED

Sections 3(a)(10), 3(a)(11), 3(a)(13), 3(a)(14), 10(b) and 16 of the Securities Exchange Act of 1934 (15 U.S.C. § 78a, 48 Stat. 881, 78 Stat. 579; et seq.), Securities and Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5) and California Corporations Code §§ 3003, 4600, 4603, 4604, 4605, 4606, 4607 and 5000 are set forth in the appendix to this brief. Securities and Exchange Commission Rules 16a-4 and 16b-2 (17 C.F.R. §§ 240.16a-4, 240.16b-2) are reproduced in the appendix to Foremost's brief on the merits.

QUESTIONS PRESENTED

Foremost's statement of the questions presented ignores the statutory language and is based upon irrelevant matters. The questions presented are:

1. When a person becomes a beneficial owner of more than 10% of an issuer's securities as a result of a purchase of those securities, was that person a beneficial owner of the securities "at the time of the purchase"?[1]

2. Does the potential for speculative abuse test enunciated in this Court's opinion in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582 exempt a transaction in which a dissolving corporation received convertible debentures in exchange for its assets, in which the recipient of the debentures had no access to inside information about the issuer and was not likely to have such access by virtue of ownership of the debentures, in which the debentures were received solely at the insistence of their issuer and the recipient wished only cash to distribute in liquidating dividends, and in which the debentures created no rights other than a debtor-creditor relationship and were never converted into common stock?

3. When, under an underwriting agreement, the owner of debentures retains possession and the incidents of ownership and cannot benefit from a rising market and is not insulated from a falling one, is the date of the sale of the debentures the date on which the underwriting agreement

[1]In discussion of this first question, we assume arguendo that Provident "purchased" a type of "securities" within the meaning of § 16(b). As is discussed in the portion of the Argument relating to the second question presented (infra, pp. 32-48), we believe that there was no such "purchase" and that the transaction is exempt under this Court's ruling in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582.

was executed or the actual date of transfer of the debentures and relinquishment of the incidents of ownership?

4. Under a plan of complete corporate liquidation pursuant to state law, may a corporate legal owner of debentures become a liquidating agent or other similar person authorized to administer the assets of its shareholders so as to render any sale of the assets exempt from § 16(b) under Securities and Exchange Commission Rule 16a-4 (17 C.F.R. § 240.16a-4)?

5. Under a plan of complete corporate liquidation pursuant to state law, may the corporate legal owner of debentures be divested of beneficial ownership and its shareholders vested with such beneficial ownership so that § 16(b) will apply to transactions by those beneficial owners and not by the legal owner?

STATEMENT OF THE CASE

A. The facts.

As Foremost acknowledges (Foremost Br., pp. 3-4), the basic facts of this case are undisputed. Those facts, however, are not fully set forth in Foremost's brief. We therefore present the following statement:

1. Background.

Provident, now dissolved, was a personal holding company incorporated under the laws of California for the purpose of managing various assets for the benefit of its shareholders (Jt.Appx., p. A73[2]). At no time were any of

[2]The Joint Appendix is cited herein as "Jt.Appx." The Appendix to Foremost's Petition for a Writ of Certiorari is cited as "Pet.Appx." The record on appeal is cited as "R."

the officers or directors of Provident either officers or directors of Foremost (Jt.Appx., pp. A73-A74).

In late 1968, Provident tentatively decided to liquidate and to distribute its assets, or the proceeds from a sale thereof, pro rata to its shareholders (Jt.Appx., p. A74). After investigation of various proposals, Provident decided to pursue negotiations on a proposal under which Foremost would purchase most of Provident's assets (Jt. Appx., p. A74). Negotiations followed between Provident and Foremost regarding the form of the transaction and the nature of the consideration to be paid (Jt. Appx., pp. A74-A76). During all negotiations, Foremost had full access to Provident's books and records; Foremost also had access to evaluations of Provident's financial structure and its assets, both of which were prepared by Dillon, Read & Co. (Jt.Appx., pp. A137-A138). In addition, Foremost made a complete appraisal of all of Provident's assets, including its marketable and unmarketable securities and its real estate (Jt.Appx., pp. A138-A139).

To facilitate liquidation and dissolution, Provident sought to sell its assets for cash; it did not wish to receive Foremost securities in any form (Jt.Appx., p. A74). Foremost, however, insisted that the major portion of the purchase price should be in Foremost convertible subordinated debentures to be issued expressly for that purpose (Jt.Appx., pp. A74-A75). Although Provident argued that Foremost should sell securities itself if it wanted to use them to finance the purchase of Provident's assets, Foremost refused to do so (Jt.Appx., p. A75). Compromise eventually was reached under which Foremost agreed to take such steps as were necessary to accomplish the public sale, as promptly as possible

following the closing of the purchase, of one half of the debentures to be transferred to Provident (Jt.Appx., p. A75).

Tentative agreement as to the purchase price and the basic terms was reached in August, 1969 (Jt.Appx., p. A75). Negotiations continued through September, 1969. Meanwhile, on September 3, 1969, the Board of Directors of Provident determined that it would recommend dissolution and winding up of Provident as well as adoption of a plan for its complete liquidation (Jt.Appx., p. A77).

On September 8, 1969, Foremost submitted to the California Commissioner of Corporations an application for a permit to issue and to transfer debentures to Provident (Jt.Appx., pp. A77, A89-A94). An attachment to that application stated:

> "The purpose of the plan of exchange is to facilitate the proposed liquidation of Provident. Prior to a vote on the Exchange Agreement, the shareholders will vote upon a voluntary liquidation of the Company. The consummation of the exchange prior to the liquidation of Provident will give Provident the above mentioned Debentures for distribution to its shareholders. The Exchange Agreement provides for registration of the Debentures under the Securities Act of 1933" (Jt.Appx., pp. A90-A91).

At a hearing on the application, representatives of both parties expressed the opinion that the transaction was fair, just and equitable to their respective interests (Jt. Appx., pp. A46, A48).

2. The purchase agreement.

The purchase agreement, executed on September 25, 1969, provided that Foremost would purchase approxi-

mately two thirds of Provident's assets in exchange for consideration in the form of both cash and Foremost six per cent convertible subordinated debentures, due June 15, 1994, which were to be issued expressly for the purpose of acquiring Provident's assets (Jt.Appx., pp. A75-A76; Purchase Agt. (following Jt.Appx., p. A34), p. 1, par. 1). It also provided that, following the closing of the agreement, Provident could distribute to its shareholders, as part of its plan of liquidation and dissolution, the Foremost debentures delivered pursuant to the purchase agreement (Jt.Appx., p. A76; Purchase Agt. (following Jt. Appx., p. A34), p. 8, par. 5(i)(j)). The debentures, however, could not be sold without the prior written consent of Foremost unless registered under the Securities Act (ibid.).

With respect to the proposed sale of one half of the debentures, Foremost agreed to use its best efforts to file a registration statement covering those debentures as soon as practicable after the date of the agreement (Jt. Appx., p. A76; Purchase Agt. (following Jt.Appx., p. A34), pp. 8-10, par. 5(k)(i)). Foremost also agreed to enter into an underwriting agreement whereby those debentures would be sold to the public (ibid.). It was contemplated at the time that all the debentures would be distributed to Provident's shareholders who in turn would sell one half of the debentures distributed to them (Jt. Appx., p. A76).

3. Provident's plan of liquidation.

On September 26, 1969, the Provident Board of Directors recommended dissolution and additionally recommended ratification of the purchase agreement executed the previous day (Jt.Appx., pp. A77-A78, A95-A98). At a share-

holders' meeting later that same day, Provident's shareholders elected to dissolve and a plan of complete liquidation was adopted (Jt.Appx., pp. A78, A99-A107). The purchase agreement was then approved by the shareholders (Jt.Appx., pp. A78, A99-A101).

The Form S-1 registration statement, filed by Foremost with the Securities and Exchange Commission on September 29, 1969, anticipated that the offering would be made by the Provident shareholders who were to receive the debentures in a liquidating distribution by Provident (Jt. Appx., p. A78; Form S-1 (following Jt.Appx., p. A112), pp. 14, 20). Early in October, 1969, however, difficulties were encountered with respect to the proposed public offering by Provident's shareholders (Jt.Appx., p. A80). In particular, it was impossible to get consents to sell from the minor shareholders without the appointment of guardians; in addition, one shareholder was somewhere in the Brazilian jungles and could not be contacted (ibid.). To resolve this problem, Foremost agreed to a change in the Underwriting Agreement so that Provident, instead of its shareholders, might sell one half of the debentures (Jt.Appx., pp. A81, A129; Underwriting Agt. (following Jt.Appx., p. A134)).

At a meeting on October 13, 1969, the Provident Board of Directors declared the first liquidating dividends, directing distribution of all of Provident's assets "pro rata to shareholders of record • • • as expeditiously as possible" (Jt.Appx., pp. A79, A120).

4. The debentures.

At the closing of the purchase agreement on October 15, 1969, Foremost delivered a check and debentures to

Provident (Jt.Appx., p. A81). Prior to acquisition of the debentures, Provident had no legal or beneficial ownership in any security of Foremost (Jt.Appx., p. A73). The debentures themselves created a debtor-creditor relationship between their issuer and their holders (see Indenture (Exh. C to Hudson Aff.)).[3] They extended to their holders no voting rights in Foremost's affairs (ibid.). Although convertible into common stock, none of the debentures were converted by Provident. Rather, pursuant to the agreement of the parties, they were either distributed to the Provident shareholders or sold (Jt.Appx., pp. A81-A82).

On October 20, Provident instructed the First National City Bank, as trustee, to distribute pro rata to Provident's shareholders the debentures which were not to be sold (Jt. Appx., pp. A82, A131). The actual mailing of those debentures took place on October 24, 1969 (Jt.Appx., pp. A82, A132-A133).

5. The underwriting agreement and subsequent events.

On October 21, 1969, the underwriting agreement covering the remaining one half of the debentures was executed by Foremost, Provident and the underwriters (Jt. Appx., p. A82; see Underwriting Agt. (following Jt.Appx., p. A134)). On the same day, the amended S-1 registration statement filed by Foremost covering those debentures became effective (Jt.Appx., p. A71). That statement had been amended to provide that the sale would be made through Provident and that

[3]This exhibit was apparently not forwarded to this Court with the record. With the consent of petitioner, we have lodged a copy with the Clerk.

> "* * * the proceeds of the sale of the Debentures offered hereby and the remaining Debentures issued or to be issued to Provident will be distributed by Provident to its shareholders in a liquidating distribution" (Form S-1 Amendment No. 2 (following Jt.Appx., p. A116), p. 14).

The underwriting agreement closed, as provided therein, on October 28 and Provident delivered possession and ownership of the debentures at that time (Jt.Appx., p. A82; Underwriting Agt. (following Jt.Appx., p. A134), pp. 1-2, par. 2). At the closing, the underwriters delivered $25,366,666.66 to Provident in New York clearing house funds in exchange for debentures in the principal amount of $25,000,000 (Jt.Appx., p. A82). After waiting the necessary 24 hours for the check drawn on the New York clearing house funds to clear, Provident distributed the cash to its shareholders (ibid.).

Liquidation proceedings continued throughout late 1969 and 1970 (Jt.Appx., p. A83). On August 31, 1970, Provident was declared dissolved by court order and its remaining assets were transferred to a liquidating trust (Jt. Appx., p. A83).

B. The proceedings below.

The decision of the district court: The district court granted Provident's motion for summary judgment on the question of nonliability. The court based its decision on an examination of "the overall character of the transaction and its ultimate effect" (Pet.Appx., p. 39a; 331 F.Supp. 791), concluding that the transaction was not subject to speculative abuse (Pet.Appx., pp. 39a-41a; 331 F.Supp.

791-792). The district court did not pass upon any of the other grounds advanced by Provident.

The decision of the Court of Appeals: On appeal, the Court of Appeals affirmed the judgment because Provident had not owned any security of Foremost when it entered into the contract under which it received the Foremost debentures. The court held that therefore Provident was not a beneficial owner of any security of Foremost "at the time of the purchase" (Pet. Appx., pp. 11a-29a; 506 F.2d 607-615).

The question whether any actual profit was realized and, if so, the amount of such profit was left open in the proceedings below and was not decided by either the district court or the Court of Appeals.[4]

SUMMARY OF ARGUMENT

1. Section 16(b) expressly provides that it is designed to prevent "the unfair use of information which may have been obtained by [an insider] by reason of his relationship" to the corporation. Insofar as it applies to a beneficial owner of more than 10 per cent of the corporation's securities, that relationship must exist "both at the time of the purchase and sale, or the sale and purchase, of the security involved." Stockholders were included within § 16(b) because an

[4]We do not agree with Foremost's argumentative characterizations of the opinions below (see Foremost Br., pp. 12-16). For example, the district court did not "concede" that "a starkly literal reading of Section 16(b)" would render Provident liable (ibid., p. 13). The portion of the opinion quoted is a paraphrase of a Foremost argument which the district court rejected (see Pet.Appx., p. 38a; 331 F.Supp. 791). Most of Foremost's argumentative characterizations are not, however, relevant to the questions before this Court. To the extent that they are relevant, we comment upon them in the Argument which follows.

owner of a large quantity of stock may have access to inside information. But one who has become an owner of more than 10 per cent of a corporation's securities by virtue of a purchase of those securities could not have made his purchase based upon inside information obtained from a relationship with the corporation which did not yet exist. Hence, such a purchase is not subject to § 16(b) because it could not have been part of a short-swing transaction undertaken with the access to inside information which is presumed under the statute.

2. The transaction was not an orthodox cash purchase of securities by Provident and involved no potential for speculative abuse under the test laid out by this Court in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 597. The Foremost debentures acquired by Provident, although convertible into common stock, were never converted by Provident and they gave Provident no rights in Foremost other than as a creditor. In negotiations between the parties, Foremost had access to information about Provident but, as a debenture holder, Provident had no inside information about Foremost and no right to obtain such information.

3. Before the sale, Provident had distributed approximately one half of the debentures and the remaining debentures were convertible into less than 10 per cent of Foremost's common stock. Consequently, Provident was not, at the time of the sale, an insider subject to § 16(b).

4. The transaction was exempt from § 16(b). Provident was a liquidating agent within the exemption set forth in Rule 16a-4. In any event, Provident had no beneficial ownership of the debentures at the time of the purchase and sale.

ARGUMENT

I. THE COURT OF APPEALS CORRECTLY DETERMINED THAT § 16(b) WAS INAPPLICABLE TO THE TRANSACTION BECAUSE PROVIDENT HAD NO OWNERSHIP OR OTHER INTEREST IN FOREMOST AT THE TIME OF THE ACQUISITION OF THE FOREMOST DEBENTURES.

A. The express terms of § 16(b), the statute's purpose and its history demonstrate that § 16(b) applies to beneficial owners of securities who are, by virtue of their relationship to the issuer, in a position to abuse inside information both at the time of the purchase and of the sale.

1. Under the terms of the statute, a beneficial owner must be such both at the time of the purchase and of the sale.

Section 16(b) is a rule of limited application which does "not reach every transaction in which an investor actually relies on inside information" (*Reliance Electric Co. v. Emerson Electric Co.* (1972) 404 U.S. 418, 422). As Foremost acknowledges, § 16(b) was directed against "*those in control* of large corporations [who] had used inside information or had manipulated the affairs of their corporations to profit from short-term speculative trading in their corporations' securities" (Foremost Br., p. 18; emphasis added). The beneficial owners of more than 10% of the securities of a corporation were included in § 16(b) because Congress determined that, by ownership of a large number of shares, an individual could obtain access to inside information and could utilize that information to engage in speculative short-swing transactions. Mr. Pecora, counsel for the Senate Committee conducting hearings on the proposed Exchange Act, observed:

> "The theory was that the ownership of 5 percent of the stock [the amount then specified in the proposed legislation] would practically constitute him an insider, and *by virtue of that position he could acquire confidential information* which he might use for his own enrichment by trading in the open market, against the interests of the general body of the stockholders. That is the main purpose sought to be served" (Hearings on S.Res. 84, S.Res. 56 and S.Res. 97, Senate Comm. on Banking and Currency, 73rd Cong. (1934) (hereinafter "Senate Hearings"), p. 7741; emphasis added).

Hence, there can be no presumption of access to inside information until after such time as one has become an owner of more than 10% of an issuer's securities. Even the Second Circuit—which has held contrary to the opinion below—has conceded that:

> "The statutory reference to a ten percent beneficial owner rests on the presumption that an owner of this quantity of securities has access to inside information. • • • [T]his presumption would not justify the conclusion that one who purchases a quantity of shares which makes him a ten percent beneficial owner has done so on the basis of inside information • • • • " (*Newmark v. RKO General, Inc.* (2 Cir. 1970) 425 F.2d 348, 356).

It is for precisely this reason, we submit, that § 16(b) is not applicable to the instant transaction. This Court, in rejecting the argument that preacquisition calculations by one later becoming a 10% beneficial owner should be considered in relation to the possibility of speculative abuse, noted that such calculations

> "• • • do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from substantial stockholdings that did not yet exist" (*Kern*

County Land Co. v. Occidental Corp. (1973) 411 U.S. 582, 597).

Similarly, a person making a decision to purchase stock which will make him an owner of more than 10% of a corporation's outstanding stock could not have made that decision "based on inside information obtained from substantial stockholdings that did not yet exist." Accordingly, § 16(b) is not applicable to short-swing transactions by that person until after he becomes a statutory insider.

Section 16(b) expressly specifies that it is designed to prevent "the unfair use of information which may have been obtained by [an insider] *by reason of his relationship to the issuer.*" It is, by its terms, directed against short-swing transactions—a "purchase *and* sale" or "sale *and* purchase" within six months. It requires, in the case of a beneficial owner, that the relationship with the issuer exist at both ends of the short-swing transaction—"both at the time of the purchase and sale, or the sale and purchase, of the security involved." Obviously, no information could possibly be obtained by reason of a relationship to the issuer until the relationship actually exists. It cannot, therefore, be presumed that an outsider whose purchase makes him a more than 10% owner has made that purchase on the basis of inside information. Hence, the necessary relationship from which access to inside information can be presumed does not exist at one end of the short-swing transaction and it should not be subject to § 16(b).

Furthermore, the phrase "at the time of" modifies both "purchase" and "sale." Insofar as a sale is concerned, it cannot be disputed that the term "at the time of" means

before giving effect to the sale. Thus a sale by a more than 10% shareholder is subject to the Act because that shareholder is presumed to have access to inside information by virtue of a relationship to the corporation. By the same token, the required 10% status must be achieved before, rather than as a result of, a given purchase. The relationship of insider therefore must antedate both the purchase and the sale in order for liability to attach.

Foremost uses the phrases "at the time of the purchase," "when the purchase occurs," and "simultaneously with the purchase" interchangeably (see Foremost Br., pp. 26-27; and see Allis-Chalmers Br., p. 12). However, to prevail, Foremost must attribute the meaning "as a result of the purchase" to all those phrases. One of the commentators relied upon by Foremost (Foremost Br., pp. 24, 31), in discussing whether a purchaser of more than 10% of the shares of a corporation is a beneficial owner "at the time of the purchase," pointed up the difficulty with Foremost's semantic argument. He noted that the words "at the time of the purchase" must mean either "before the purchase or after giving effect to the purchase" (Seligman, Problems under the Securities Exchange Act (1934) 21 Va.L.Rev. 1, 20). In the case of the second step of a short-swing transaction, the sale (or the "resale"),

> "* * * the words 'at the time' must mean immediately before the resale, for if they mean after giving effect to the resale, then the effect of the quoted language would be to render Section 16(b) practically ineffective since it could be avoided by a single sale of all the stock owned. Accordingly, if the words 'at the time' are to be given the meaning of immediately before in the case of the resale, the same meaning

would seem necessary in the case of the purchase. From this it would follow that the transaction under discussion comes within the exception contained in the quoted language" (ibid.).

Although that commentator went on to reject such a reading of "at the time of" when applied to a purchase, he did so without any examination of the statutory purpose and history. He engaged, as does Foremost (Foremost Br., pp. 20-21), in the simplistic syllogism: (1) that speculative abuse might be possible in some transactions, (2) that the proposed interpretation could prevent that asserted abuse and (3) that, therefore, the proposed interpretation should be adopted. Such an argument is no answer to the interpretative inquiry before this Court. Although there have been declarations that § 16(b) should be broadly interpreted to effectuate its purpose (see, e.g., Foremost Br., pp. 20-22), the courts heretofore have clearly pointed out that it may not be expanded to deal with supposed speculative abuses which are beyond its intended scope. Indeed, this Court has already considered —and rejected—precisely the same syllogism presented by Foremost. It has expressly refused to extend § 16(b) "to include all persons realizing 'short swing' profits who either act on the basis of 'inside' information or have the possibility of 'inside' information" *(Blau v. Lehman* (1962) 368 U.S. 403, 411).

2. No court other than the court below has examined the proviso here in question in light of its purpose and history.

Foremost seeks to impress this Court with the asserted "clear weight of authority" (Foremost Br., p. 20), but that weight does not hold up under close scrutiny. Two other Courts of Appeals have passed upon the question here in issue. The Second Circuit approved, without analysis, the holding of a district judge that an initial acquisition of more than 10% was a purchase within the statute *(Stella v. Graham-Paige Motors Corporation* (2 Cir. 1956) 232 F.2d 299, 300-301, affirming *Stella v. Graham-Paige Motors Corp.* (S.D.N.Y. 1952) 104 F.Supp. 957, 959). The district judge in *Stella* did not directly address the question whether a purchase by an outsider of more than 10% should be within the statute. Rather, he based his decision solely upon the fear that, unless "at the time of" were interpreted to mean "as a result of," then certain *sales and repurchases* would be exempt from § 16(b) coverage. He declared that, if "at the time of" the repurchase meant "before giving effect to" such repurchase,

> "* * * it would be possible for a person to purchase a large block of stock, sell it out until his ownership was reduced to less than 10%, and then repeat the process, ad infinitum" (104 F.Supp. 959).

As the Ninth Circuit pointed out, such a result does not follow. A sale by a more than 10% holder to less than 10% and a repurchase by him would be subject to § 16(b) because such a shareholder

> "* * * was within a class of persons who had access to inside information by reason of their relationship

to the issuer prior to making his initial decision to speculate * * *" (Pet.Appx., p. 26a; 506 F.2d 614).[5]

After the decision in *Stella,* the question came before the Eighth Circuit. That court, observing that the question was "difficult and not free of all doubt" and commenting upon the "paucity of judicial decision on the precise question presented," decided to follow the Second Circuit *(Emerson Electric Co. v. Reliance Electric Company* (8 Cir. 1970) 434 F.2d 918, 923, affirmed on other grounds, *Reliance Electric Co. v. Emerson Electric Co.* (1972) 404 U.S. 418). Neither the Second Circuit nor the Eighth Circuit examined the legislative history of the proviso. The Second Circuit subsequently has adhered to its views *(Newmark v. RKO General, Inc.* (2 Cir. 1970) 425 F.2d 348, 355-356; *Perine v. William Norton & Company, Inc.* (2 Cir. 1974) 509 F.2d 114, 118) and a district court in the Seventh Circuit, again without analysis, followed the Second Circuit *(Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.* (N.D.Ill. 1974) 372 F.Supp. 570, 576; appeal pending).

[5]This view had been endorsed earlier by a commentator on § 16(b):

"* * * there is nothing inconsistent with the view that, in the hypothetical situation posed by the court in *Stella,* where because of the insider status of a person owning a large block of stock he is given access to inside information, a sale followed by a purchase which restores him to insider status should result in liability; yet this should not be so in the converse situation, that of a purchase by an outsider followed by a sale within six months." (Painter, Federal Regulation of Insider Trading (1968) p. 41).

Although some commentators have agreed with the interpretation of the Second Circuit (see Foremost Br., pp. 21-22), others have disagreed.[6] In particular, all those who have examined the legislative history have reached the same conclusion as the Ninth Circuit (Comment, Insider Liability for Short-Swing Profits: The Substance and Function of the Pragmatic Approach (1974) 72 Mich. L.Rev., 592, 602-606, 616-619; Comment, Section 16(b): An Alternative Approach to the Six-Month Limitation Period (1973) 20 UCLA L.Rev. 1289, 1312, ftn. 125; Note, Short-Swing Profits and the Ten Percent Rule (1957) 9 Stan.L.Rev. 582).

Foremost's reference (Foremost Br., pp. 22-23) to cases involving officers and directors is irrelevant. The statute itself distinguishes between directors and officers on the one hand and beneficial owners on the other, *requiring only in the case of beneficial owners that the relationship must exist "both at the time of the purchase and sale."* For that reason, it has been long recognized that "the statute evidences a clear legislative intent to treat corpo-

[6]One of the first commentators on § 16(b) stated:

"Let us assume a case where a stockholder owns somewhat less than 10% of the stock. He buys additional stock, which gives him more than 10%. Without buying any more he subsequently sells some of his stock at a profit. He is not liable to the corporation, because he was not a 10% stockholder at the time of purchase. Of course, *officers and directors* are liable for the profits whether they own 10% of the stock or not" (Meyer, The Securities Exchange Act of 1934, (1934) p. 112; emphasis in original).

Later commentaries have been in accord (e.g., Painter, Federal Regulation of Insider Trading (1968) pp. 41-42; Munter, Section 16(b) of the Securities Exchange Act of 1934: An Alternative to "Burning Down the Barn in Order to Kill the Rats" (1966) 52 Cornell L.Q. 69, 74-75; Cole, Insiders' Liabilities under the Securities Exchange Act of 1934 (1958) 12 Southwestern L.R. 147, 155-157).

rate directors and officers in one category of insiders and 10% shareholders in another" (*Feder v. Martin Marietta Corporation* (2 Cir. 1969) 406 F.2d 260, 266-267). As has been pointed out,

> "There is, of course, a logical and practical basis for distinction. Generally, although there are important exceptions in certain circumstances, officers and directors have more ready access to the intimate business secrets of corporations and factors which can affect the real and ultimately the market value of stock than does even so large a stockholder as a '10% beneficial owner'" (*Adler v. Klawans* (2 Cir. 1959) 267 F.2d 840, 845).

3. The purpose and the legislative history of § 16(b) support the conclusion that it applies to beneficial owners of securities who are, by virtue of their ownership, in a position to abuse inside information at the time of the purchase.

Section 16(b) was designed to deal with short-swing transactions by corporate insiders. Stockholders were included within that class of insiders because ownership of a large quantity of stock could result in access to inside information. It was against this background that Congress specified that the statute would not be applicable to more than 10% beneficial owners unless they were such "both at the time of the purchase and sale."

In addition to the considerations already mentioned, the legislative history also supports the conclusion that § 16(b) was directed at short-swing transactions by beneficial owners when those owners entered into the short-swing transaction in a position to utilize inside information. Both Foremost (Foremost Br., p. 29) and amicus Allis-Chalmers (Allis-Chalmers Br., p. 15) concede that the

initial draft of what is now § 16(b)—Senate Bill 2693 and House Bill 7852—made it clear that insider status must *precede* the questioned purchase.[7] Thomas Corcoran, one of the chief draftsmen of the statute, explained that the purpose of the section was to prevent

> "* * * any short-term speculations in the stock. He [an insider] cannot, *with his inside information get in and out* of stock within six months" (House Hearings p. 133; emphasis added).

Foremost (Foremost Br., p. 29) and amicus Allis-Chalmers (Allis-Chalmers Br., pp. 15-16) point out that the initial bills were amended and Foremost protests that the "weight" to be given to them "escapes" it (Foremost Br., p. 29, ftn.). That "weight", however, is clear. The initial bills were the subject of most of the hearings held by both the Senate and House Committees and almost all comments in the legislative history were directed at them. In particular, Mr. Corcoran's now-famous "crude rule of

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[7]Those bills provided:

> "(b) *It shall be unlawful for any* director, officer, or *owner of securities, owning* as of record and/or beneficially *more than 5 per centum of any class of stock* of any issuer, any security of which is registered on a national securities exchange—
>
> "(1) *To purchase* any such registered security with the intention or expectation of selling the same security within six months: and any profit made by such person on any transaction in such a registered security extending over a period of less than six months shall inure to and be recoverable by the issuer, irrespective of any intention or expectation on his part in entering into such transaction of holding the security purchased for a period exceeding six months" (S. 2693, printed at Senate Hearings, p. 6430; H.R. 7852, printed at Hearings on H.R. 7852 and H.R. 8720, House Comm. on Interstate and Foreign Commerce, 73rd Cong. (1934) (hereinafter "House Hearings"), p. 9; emphasis added).

thumb" comment was directed at the § 16(b) provision as it appeared in Senate Bill 2693.[8] It was that comment, and others directed at the original language as it appeared in Senate Bill 2693 and House Bill 7852, which underlie the judicial conclusions regarding the prophylactic purposes of § 16(b) (e.g., *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 591-593; *Blau v. Lamb* (2 Cir. 1966) 363 F.2d 507, 515-516; *Western Auto Supply Company v. Gamble-Skogmo, Inc.* (8 Cir. 1965) 348 F.2d 736, 743; *Smolowe v. Delendo Corporation* (2 Cir. 1943) 136 F.2d 231, 235-236). Thus, these original bills were deemed by their drafters to contain the "flat rule" of strict application which eliminated the need to prove intention or expectation. And, that strict flat rule clearly did not apply to the initial purchase by which one became a beneficial owner subject to the statute.

The hearings contain no suggestion by anyone that the provisions applicable to beneficial owners should be made more stringent. To the contrary, although there was agreement that directors and officers should be included within the scope of § 16(b), concern was expressed whether beneficial owners should be included at all (see Senate Hearings, p. 6556; and see discussion at Pet.Appx., pp. 20a-23a, 506 F.2d 611).[9] Concern was also expressed that the section should be amended to cover a sale and repurchase as well as a purchase and sale (Senate Hearings, pp. 6557-6558; and see discussion at Pet.Appx., pp. 17a-18a, 506 F.2d 610).

[8]Mr. Corcoran explained the purpose and operation of § 16(b) as follows:

> "[Section 16(b)] is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing" (Senate Hearings, p. 6557).

The bills were thereafter amended to include a sale and repurchase.[10] The declaration of purpose was added which stated that § 16(b) was directed against "the unfair use of *information* which may have been *obtained* by [an insider] *by reason of his relationship* to the issuer" (emphasis added). It was at this time that Congress evidenced its intent to retain the previous bills' application to beneficial owners who were insiders at the time of entering into the short-swing transaction. It required that, in the case of such a beneficial owner, the relationship with the issuer must exist "both at the time of the purchase and sale * * * of the security involved." Plainly, no information can be obtained "by reason of" a relationship arising from "the security involved" when that relationship does not yet exist.

[9]The House went so far as to delete the § 16(b) provision in its entirety; it was reinstated in conference (see Congressional Record (1934) 73rd Cong., pp. 8036-8038; H.Rept. No. 1838 (1934) 73rd Cong., pp. 35-36).

[10]That this was a major reason for revision of the section is clear and was pointed out by the Ninth Circuit (Pet.Appx., p. 19a; 506 F.2d 610-611). Contrary to the assertion of amicus Allis-Chalmers, the Ninth Circuit did not "speculate" that the statute was changed to ameliorate the difficulty of proving intention (Allis-Chalmers Br., p. 15). The Ninth Circuit correctly pointed out that the original draft, as all subsequent ones, contained a presumption of intention (Pet.Appx., p. 19a; 506 F.2d 610-611).

The congressional comments and the language added to § 16(b) thus show no change in the statute's aim at beneficial owners who made the questioned purchase *at a time when they could be presumed to have access to inside information.* This is further evidenced in the hearings that followed the changes in the language. House Bill 8720—to which the "present language of § 16(b) can be traced" (Allis-Chalmers Br., p. 15; and see Foremost Br., p. 29)—was discussed by Mr. Pecora, the Committee Counsel, and Mr. Samuel Untermyer, a New York attorney upon whose expertise the Senate Committee relied.[11] Their discussion indicates that, under House Bill 8720, the specified amount of beneficial ownership had to precede a questioned purchase before liability would arise. In response to Mr. Untermyer's argument that the amount of beneficial ownership should be raised from the 5% figure which appeared in House Bill 8720 (Senate Hearings, pp. 7741, 7742), Mr. Pecora noted that:

> "[The section] is designed avowedly to prevent insiders from utilizing their position to trade for their own account and against the interests of the general body of the stockholders. The only penalty against it, as you have observed, is that he has to disgorge his profits for the benefit of all the stockholders" (ibid., p. 7742).

[11]H.R. 8720 was introduced on March 19, 1934; the Senate bill (S. 3420) containing the same language was not introduced until April 20, 1934. However, H.R. 8720 was before the Senate Committee and was the subject of comments directly after its introduction and before introduction of the Senate version (see Senate Hearings, p. 7715).

Mr. Untermyer then declared:

> "*That is a penalty that will prevent him from buying any more stock*, and you will hurt the market in the stock. He may have to buy to protect the stock.
>
> * * * * *
>
> " * * * [H]e may just buy for the purpose of protecting the stock, and he may want to sell it as soon as he can" (ibid.; emphasis added).

Thus, short-swing transactions by beneficial owners who were *already* insiders and who could obtain inside information by virtue of their relationship to the corporation were subject to the penalties prescribed in House Bill 8720. The concern expressed was that such penalties would prevent such beneficial owners "from buying any more stock" for such purposes as protecting existing holdings (Senate Hearings, p. 7742). There is absolutely nothing which would indicate that Congress altered its original intent that, in the case of a beneficial owner, insider status must precede the questioned purchase in order for there to be liability under the statute. Indeed, the history of the statute makes it apparent that such intent was retained.

B. Foremost's arguments are founded upon misconceptions of the statute's purpose and history.

Foremost refers to § 16(d) of the Exchange Act as asserted "contemporaneous" evidence in support of its interpretation, erroneously contending that the problems which were the concern of that section "would not have arisen if the interpretation adopted by the Ninth Circuit were indeed the interpretation contemplated by Congress" (Foremost Br., pp. 30-31, 32; and see Allis-Chalmers Br.,

pp. 14-15). This argument misconstrues § 16(d) and ignores its clearly stated purpose. In the first place, what is now § 16(d) was not enacted until 1964 (Public Law 88-467 (1964) 78 Stat. 579) and therefore cannot be deemed contemporaneous evidence of anything with respect to § 16(b). In the second place, § 16(d) was a part of the amendments which extended coverage of the Exchange Act to over-the-counter securities. Section 16(d) was included in the law not because of any concern about beneficial owners but rather to deal with "transactions of a broker-dealer who is making a market in a security while represented on the issuer's board of directors" (S.Rept. No. 379 (1963) 88th Cong., 1st Sess., p. 22). The legislative history makes it clear that Congress believed that such broker-dealer-directors served a legitimate market function with respect to over-the-counter securities. The intent of § 16(d) was to avoid unnecessarily penalizing such directors:

> "If section 16(b) were applied to market-making transactions by such broker-dealer-directors, they would be compelled, as a practical matter, to cease their market-making activities or resign their directorships. To avoid requiring them to choose between the two alternatives, S. 1642 would add a new subsection (d) to section 16 to exempt over-the-counter transactions in securities by dealers in the ordinary course of business and incident to the establishment or maintenance of primary or secondary market for such securities, provided the securities have not been held in the dealer's investment account" (S.Rept. No. 379 (1963) 88th Cong., 1st Sess., pp. 22-23; see also Congressional Record (1964) 88th Cong., 2nd Sess., pp. 17921, 17926-17929, 18181, 18182-18183).

Lastly, even if all the above were not true, § 16(d) would nonetheless be necessary to exempt certain transactions by beneficial owners under the Ninth Circuit's interpretation of § 16(b) as well as under Foremost's interpretation. A dealer trading to maintain a market in a security could acquire more than 10% beneficial ownership by virtue of one or more purchases and then could make additional purchases. In the absence of § 16(d), such purchases would be subject to § 16(b).

Amicus Allis-Chalmers also erroneously asserts that the arbitrage exemption provided by § 16(e) would not "have been necessary" if the transaction by which one becomes a more than 10% beneficial owner were not subject to § 16 (b) (Allis-Chalmers Br., p. 17). However, one engaging in arbitrage transactions exempted by § 16(e) could acquire more than 10% in one transaction and could thereafter make other purchases or engage in sales and repurchases. Similarly, Rule 16b-2 is broader in scope than recognized by either Foremost or amicus Allis-Chalmers (see Foremost Br., pp. 24-25; Allis-Chalmers Br., pp. 17-18). That Rule applies to transactions by underwriters and is applicable to normal market stabilization activities undertaken by them. Such transactions clearly could involve purchases and sales, or sales and repurchases, after an underwriter attains the status of a more than 10% beneficial owner, such as in connection with a public offering being handled by the underwriter for the issuer.

Foremost also errs in its reference (Foremost Br., pp. 27-28) to a Senate Report which was issued after enactment of the Exchange Act. The section of the Report to which Foremost refers (S.Rept. No. 1455 (1934) 73rd

Cong., 2nd Sess., pp. 55-68) discussed § 16 generally, without specific mention of the proviso here in question. The principal concern of the section was purchases and sales by persons who were already insiders, in particular the "participation by officers, directors, and principal stockholders in pools involving their own securities" (ibid., pp. 55-56). Foremost's statement about "promotors and market manipulators who were granted interests in large blocks of stock" (Foremost Br., p. 27) presumably refers to the influential brokers who were sometimes enlisted in pool operations by means of the grant of stock options. Those brokers then sought to stimulate the market in the stock so as to benefit themselves and the insiders who granted the options (see S.Rept. No. 1455 (1934) 73rd Cong., 2nd Sess., pp. 55-62). The Report does not discuss application of § 16(b) specifically to such optionees and, insofar as it does discuss their activities, its focus is upon their operations *after* receiving the options and thus after attaining insider status.[12]

Foremost also mistakenly attempts to find comfort in this Court's opinion in *Reliance Electric Co. v. Emerson Electric Co.* (1972) 404 U.S. 418 (see Foremost Br., pp. 31-32). In *Reliance*, it was expressly noted that the question here in issue was not before the Court (404 U.S. 421). The opinion does emphasize, however, that "a 10% owner must be such both at the time of the purchase and of the sale" and it cautions that the proviso "cannot be disregarded simply on the ground that it may be inconsistent

[12]For example, with respect to one such optionee, the Report notes: "During the life of the four options Cutten bought and sold approximately 100,000 shares, assuming at times a long position and at times a short position" (ibid., p. 59).

with our assessment of the 'wholesome purpose' of the Act" (404 U.S. 424).

Foremost's attempted distinction of *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582 is equally unavailing. In that case, this Court commented upon the obvious fact that one *becomes* a statutory insider as a result of acquisition of more than 10% of a corporation's outstanding stock (411 U.S. 584, 595, 598). Although Foremost places great reliance on statements to this effect (Foremost Br., p. 36; and see Allis-Chalmers Br., p. 8), those statements plainly do not deal with the question whether one *is* a statutory insider "at the time of" entry into the contract by which the stock was acquired.

The opinion did not pass directly upon this question. However, it did, as noted above (pp. 13-14), reject the argument that preacquisition calculations by those about to become 10% beneficial owners should be considered in determining the possibility of speculative abuse. Such calculations, this Court said,

> "* * * do not represent the kind of speculative abuse at which the statute is aimed, for they could not have been based on inside information obtained from substantial stockholdings that did not yet exist" (411 U.S. 597).

Foremost suggests that this Court did not mean what it said, erroneously asserting that "it is the potential for obtaining inside information, not the ripening of equity ownership, which is the important factor" (Foremost Br., p. 33). This assertion is based upon Foremost's contention that the statute contemplates a relationship "sufficient to permit the abuse of inside information" in the absence of

an ownership of "substantial stockholdings" (Foremost Br., pp. 33-35). That contention ignores the rationale which underlies § 16(b) and demonstrates a complete misunderstanding of the statute. Ownership of "substantial stockholdings" exists, under the statute, as a result of a "purchase" of more than 10% of a class of "equity security" as defined therein. If one is not a beneficial owner of such an equity security, then there can be no presumed access to inside information and no liability under § 16(b). Whether or not the presumption of access to information is reasonable or should be made in a given situation is an entirely different matter.[13] The point, for purposes of Foremost's argument, is that the statute defines the ownership of stockholdings from which the presumption of access to inside information arises and that ownership necessarily precedes the presumed access. If such access in fact did exist without substantial stockholdings, then the Act provides other remedies.

Certainly, one may engage in conjecture about various possibilities of speculative abuse in different factual contexts.[14] However, § 16(b) is a rule of limited application

[13]It is because "the statutory definitions of 'purchase' and 'sale' are broad" that this Court endorsed the pragmatic test which inquires "whether the transaction may serve as a vehicle for the evil which Congress sought to prevent—the realization of short-swing profits based on access to inside information" (*Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 594). The applicability of that test, and the reasonableness of a presumption of access to inside information from the existence of a mere debtor-creditor relationship, are discussed below (infra, pp. 32-48).

[14]As Foremost stresses throughout its brief (Foremost Br., pp. 2, 3, 14-15, 16, 17, 27, 52), the court below hypothesized about the possibility of speculative abuse in the transaction here in question. As is discussed below, we believe that the court's conjecture on that question was in error (see discussion, infra, pp. 42-45).

and different remedies exist for different situations, including actions for fraud in general, stockholders' derivative actions, and other provisions of the Exchange Act. Foremost's complaint that § 10(b) of the Exchange Act (15 U.S.C. § 78j(b), 48 Stat. 891) is not self-operative (Foremost Br., pp. 28-29) is beside the point. As the Ninth Circuit noted (Pet.Appx., pp. 28a-29a; 506 F.2d 615), § 10(b) was enacted at the same time as § 16(b) to provide a remedy to purchasers and sellers of securities for injuries resulting from "manipulative or deceptive" practices (15 U.S.C. § 78j(b), 48 Stat. 891). It is a matter of common knowledge that § 10(b), and Rule 10b-5 (17 C.F.R. § 240.10b-5) formulated under it, have been used with increasing effectiveness (see generally, *American Standard, Inc. v. Crane Co.* (2 Cir. 1974) 510 F.2d 1043, 1062-1063; Loss, Securities Regulation (Supp. 2d Ed. 1969) Vol. VI, p. 3559).

Lastly, Foremost's "passing" comment on a supposed "anomaly" (see Foremost Br., p. 35) is based upon its continuing failure to recognize that a presumption of access to information by a beneficial owner is founded upon the *ownership* of securities and that liability under § 16(b) is dependent upon that ownership. Various "deliveries" under one contract are without significance because it is the ownership, not the possession, of securities which gives rise to the presumption. It is the statute itself which requires that some purchases by beneficial owners be excluded. And, for the reasons discussed above, the statute excludes purchases by outsiders who do not have more than 10% ownership, and thus cannot be presumed

to have access to inside information, "at the time of the purchase."

II. THE TRANSACTION WAS NOT SUBJECT TO SPECULATIVE ABUSE.[15]

In ruling that the transaction was not exempt under this Court's holding in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, the Ninth Circuit held (1) that the transaction was "orthodox" and therefore not subject to the *Kern County* ruling and (2) that, in any event, it was subject to § 16(b) (Pet.Appx., pp. 4a-8a; 506 F.2d 604-606). Both of these conclusions were in error.

As in *Kern County,* Provident had no prior association with Foremost and owned no Foremost securities before the transaction here in question. As a result of the transaction, Provident acquired debentures, not stock, and it did not have nor was it likely to have access to information by virtue of that acquisition. Therefore, the transaction was not of the type at which the statute is aimed and it did not present the opportunity for speculative abuse with which Congress was concerned. Not only would application of § 16(b)'s conclusive presumption be contrary

[15]Because a writ of certiorari runs to but one judgment, a respondent may urge all arguments in support of that judgment even though they might have been rejected by the court below or might not have been considered by it (*Stelos Co. v. Hosiery Corp.* (1935) 295 U.S. 237, 239; *Langnes v. Green* (1931) 282 U.S. 531, 535, 539). In addition to the ground already discussed, we respectfully submit that the judgment should be affirmed for each of the reasons which follow.

to this Court's opinion in *Kern County,* but it would also raise serious questions of due process of law.

A. The exchange of assets for debentures was an "unorthodox" transaction.

In *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, this Court ruled that "a 'pragmatic' approach to § 16(b) will best serve the statutory goals" (411 U.S. 594, ftn. 26) and it held that the section should be applied "only when its application would serve its goals" (411 U.S. 595). The Ninth Circuit, however, erroneously held that the transaction here in question was an "orthodox" purchase and that therefore there was no need to determine if application of § 16(b) to it would serve the statutory purpose (Pet.Appx., pp. 5a-6a; 506 F.2d 604-605). In so holding, the Ninth Circuit ignored the facts of this case which demonstrate that the transaction was not "orthodox" and not one to which the statute should be automatically applied.

Provident did not, as in a traditional cash-for-stock transaction, enter the market seeking to purchase stock. Provident did not want Foremost's, or anyone else's, stock; it wanted only cash to distribute to its shareholders in the liquidation already under way (Jt.Appx., pp. A74-A75). Nor did Provident pay cash for the Foremost debentures. Rather, it was Foremost which sought to purchase Provident's assets and it made payment in cash and in debentures "created solely for the purpose of this transaction" (Foremost Br., p. 6; and see Jt.Appx., p. A75).

Provident never received any Foremost stock but rather received debentures which, although convertible into

common stock, were never so converted by Provident. As has been observed, debentures are not ordinarily considered to be stock (*Chemical Fund, Inc. v. Xerox Corporation* (2 Cir. 1967) 377 F.2d 107, 110-111). A convertible debenture is an "equity security" under the Exchange Act

> "* * * only because of its convertible nature, since an 'equity security' is defined [in section 3(a)(11)] as 'any stock or similar security; or any security convertible * * * into such a security * * * or any such warrant or right * * * '" (377 F.2d 110).

Because a holding of debentures creates only a debtor-creditor relationship,

> "* * * there is no reason whatever to believe that any holder of any Convertible Debentures would, by reason of such holding, normally have any standing or position with the officers, directors or large stockholders of a company so that such holder of Debentures would be the recipient of any inside information" (377 F.2d 111).

Thus, the transaction was not an exchange of cash for stock and was not one which would ordinarily involve any receipt of inside information. We therefore submit that it was not a "traditional cash-for-stock" transaction which is "clearly within the purview of § 16(b)" *(Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 593).

In addition, this Court, in *Kern County,* noted that "unorthodox" transactions would include "exchanges pursuant to mergers and other corporate reorganizations" (411 U.S. 593, ftn. 24). Similarly, Professor Loss has noted that "unorthodox" transactions may include "the acquisition of securities of one company in exchange for

the assets of another" (Loss, Securities Regulation (Supp. 2d Ed. 1969) Vol. V, p. 3029).[16]

Ignoring the significant facts discussed above, the Ninth Circuit concluded that the transaction was "*essentially* a cash-for-stock transaction" because it could see "no meaningful distinction between consideration in the form of cash and consideration in the form of a corporate asset" (Pet. Appx., pp. 5a, 6a; 506 F.2d 604, 605; emphasis added; and see Foremost Br., pp. 49-50). The meaningful distinction between an orthodox and unorthodox transaction plainly exists in this case. When *cash* is utilized to purchase *stock,* it is reasonable to conclude that a party wished to acquire that stock and that therefore the transaction may involve an inherent possibility of speculation.

Provident, however, did not make a cash purchase, did not seek to acquire stock, and did not acquire stock. It received Foremost debentures as part of the consideration for its assets and it did so only at Foremost's insistence.

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[16]The court below placed reliance (Pet.Appx., p. 5a; 506 F.2d 605) on Professor Loss' statement that:

> "Conversions and merger-like transactions aside, the voluntary exchange of securities, either for assets or for other securities, at least of a different issuer, is ordinarily as much a 'purchase' or 'sale' as if the consideration had been cash" (Loss, Securities Regulation (2d Ed. 1969) Vol. II, p. 1072).

However, Provident did not exchange its securities for assets or other securities; rather, Foremost purchased Provident's assets in exchange for cash and debentures. Professor Loss does not consider any transaction in which debentures, rather than stock, were received. Furthermore, he does not state that even transactions involving stock are necessarily orthodox, noting only that they will "ordinarily" be so considered and also expressly exempting "merger-like transactions." In addition, it should be noted that the primary case cited by Loss (Loss, Securities Regulation (Supp.2d Ed. 1969) Vol. V, p. 3040) did examine the transaction to see if it would "lend itself to manipulation" (*Blau v. Lehman* (2 Cir. 1960) 286 F.2d 786, 792).

The undisputed facts demonstrate that Provident had no wish to acquire the debentures and, most importantly, that Provident never converted the debentures into stock which might arguably have given it access to inside information. The possibility of speculation was not inherent in the transaction. Therefore, the transaction should be examined to determine whether there existed any potential for speculative abuse.

Foremost's attempted defense of the Ninth Circuit's holding on this question involves two separate points: (1) that the facts of the transaction were not exactly the same as certain other unorthodox transactions in other cases and (2) that the transaction was "voluntary" (Foremost Br., pp. 50-51). As to the first point, the transaction is indeed unique and, insofar as we are aware, unlike that in any other reported case. There is, however, no suggestion in any case that the pragmatic approach endorsed in *Kern County* should be limited to the specific fact situations in already reported cases. Indeed, there is no logical reason why there should be such a limitation. As to the second point, Foremost's emphasis on "voluntariness" is misplaced. The stock option transaction in *Kern County* was wholly voluntary (411 U.S. 582-600). Moreover, no "determinative consequences" arise from the fact that a transaction was voluntary *(Blau v. Lamb* (2 Cir. 1966) 363 F.2d 507, 520, ftn. 16).

Finally, it should be noted that the Ninth Circuit's holding on the "orthodox" transaction question would engraft upon the statute an ill-defined and unnecessary requirement of determining whether a particular noncash transaction is "essentially" a cash transaction. This would

spawn a series of decisions which would attempt to define this nebulous concept. The instant transaction unquestionably did not involve any cash payment by Provident and Provident acquired debentures, not stock, of Foremost. Therefore, the transaction should be examined for a potential for speculative abuse because

> "* * * the question is not in any event primarily a semantic one, but must be resolved in the light of the legislative purpose—to curb short swing speculation by insiders" *(Ferraiolo v. Newman* (6 Cir. 1958) 259 F.2d 342, 344).

B. The transaction involved no potential for speculative abuse.

1. Provident did not have, and was not likely to have, access to inside information or any control or influence over Foremost.

As this Court has noted, the purpose of § 16(b) is

> "* * * to curb short-swing trading by insiders whose position gives them access to information not available to the investing public and the ability to influence corporate policy" *(Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 592, ftn. 23).

In order to implement the statutory purpose, this Court has endorsed those decisions which inquire "whether the particular type of transaction involved is one that gives rise to speculative abuse" *(Reliance Electric Co. v. Emerson Electric Co.* (1972) 404 U.S. 418, 424, ftn. 4).

The undisputed facts demonstrate that Provident did not have, and that there was no likelihood that it could have had, any inside information about Foremost or any influence over Foremost's affairs. Prior to the acquisition of the Foremost debentures, Provident had no ownership or

other interest in Foremost (Jt.Appx., pp. A73-A74). Therefore, Provident could not be found liable on the basis of hypothetical speculative calculations prior to the acquisition because any such calculations "could not have been based on inside information obtained from substantial stockholdings that did not yet exist" *(Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 597).

Foremost makes a misleadingly broad reference to "cooperative negotiation and exchange of information between issuer and purchaser prior to the time of purchase" (Foremost Br., p. 33). Assuming the negotiations which led to Foremost's purchase of Provident's assets to be a relevant consideration, nonetheless it is undisputed that they involved only an evaluation of *Provident's assets* which were to be transferred to Foremost. During that time, it was Foremost that had complete access to all of Provident's books and records and to complete evaluations of Provident's financial structure and its assets (Jt.Appx., pp. A137-A139). But Provident had no right to, and it did not in fact have any access to, Foremost's books and records or any other inside information about Foremost.

The situation was not altered after the consummation of Foremost's purchase of Provident's assets. As a result of the sale of its assets, Provident acquired Foremost debentures, not stock. The debentures, although convertible into common stock, were never converted by Provident. The debentures themselves did not give Provident any voting rights in the affairs of the corporation or any other incidents of corporate ownership which might arguably have provided influence over Foremost's affairs or

afforded the debenture holder access to inside information.[17]

The debentures did no more than evidence a debtor-creditor relationship. The Indenture, under which the debentures were issued and which governs the relationship between Foremost and the debenture holders, gives no rights to the debenture holders other than rights as creditors. There is nothing in the Indenture which would make inapplicable the general rule that "a debenture is usually only an obligation to pay" (Fletcher, Cyclopedia of the Law of Private Corporations (1959 Ed.) Vol. 19, § 9162, p. 374; and see § 9089, pp. 291-293). Under the terms of the Indenture, a debenture holder could not possibly obtain any access to inside information. Thus, Provident had no inside information and was not even in a position to have obtained such information "had it wanted to" (cf. *Allis-Chalmers Mfg. Co. v. Gulf & Western Indus., Inc.* (N.D.Ill. 1974) 372 F.Supp. 570, 579; appeal pending).[18]

As noted above (p. 34), a convertible debenture is considered an "equity security" under the Act only because of its convertible nature, an "equity security" being defined as "any stock or similar security; or any

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[17]For the rights of shareholders, as opposed to debenture holders, see discussion, infra, pp. 43-44.

[18]The Indenture (Exh. C to Hudson Aff.) defines in detail such matters as the issuance of the debentures, their subordination to other debts, redemption of the debentures, debenture holders' conversion rights, and rights in the event of default. Although the Hudson affidavit is a part of the record on appeal (R., pp. 119-127; Jt.Appx., pp. A24-A33), Exhibit C thereto was apparently not forwarded to this Court. With the consent of petitioner, we have lodged a copy with the Clerk.

security convertible * * * into such a security" (15 U.S.C. § 78c(a)(11)). But,

> "Nothing in the hearings which preceded passage of the Act in 1934 would indicate that the owners of Debentures as such ought to be considered as 'insiders'" (*Chemical Fund, Inc. v. Xerox Corporation* (2 Cir. 1967) 377 F.2d 107, 110).

To the contrary, the Act is not concerned with persons having only a debtor-creditor relation but with those who might be in a position to benefit by virtue of their relationship to the corporation. The reason for this is apparent: "section 16 is specifically concerned with 'directors, officers and principal stockholders,' [because] * * * they are the people who run the corporation, and who are familiar with its day to day workings" (377 F.2d 110). Moreover,

> "* * * there is no reason whatever to believe that any holder of any Convertible Debentures would, by reason of such holding, normally have any standing or position with the officers, directors or large stockholders of a company so that such holder of Debentures would be the recipient of any inside information. There is no provision which gives a holder of the Debentures any standing beyond that of a creditor entitled to certain specified payments of interest at stated intervals, and possessing numerous rights all of which are specifically spelled out in the trust indenture pursuant to which the Debentures were issued" (*Chemical Fund, Inc. v. Xerox Corporation* (2 Cir. 1967) 377 F.2d 107, 111).

In this case, Provident's acquisition of the debentures gave it nothing more than a brief status as a creditor of

Foremost with limited rights as such expressly defined in the Indenture. Provident's position as a mere creditor of Foremost remained unchanged up to and including the sale of the debentures.[19] The sale itself was pursuant to the agreement of the parties (Jt.Appx., pp. A76, A78; Purchase Agt., pp. 8-9, following Jt.Appx., p. A34) and there was full disclosure of it to the public (Jt.Appx., p. A78, A112-A116; R., pp. 515-678). As the district court noted, Foremost made no claim at the trial level that there existed in the acquisition and sale of the debentures "any of the evils against which" § 16(b) was directed

> "* * * or that Provident derived inside information, profit or advantage from its all-but-momentary status as an 'insider' of Foremost" (Pet.Appx., p. 38a; 331 F.Supp. 791).

In both the courts below, Foremost contended, as it continues to contend, only that Provident "possessed knowledge" regarding *its own* assets which were sold to Foremost (Foremost Br., p. 53; and see R., pp. 220-221). That information—all of which was made fully available to Foremost (Jt.Appx., pp. A137-A139)—did not provide

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[19]The situation should be contrasted with such cases as *Makofsky v. Ultra Dynamics Corporation* (S.D.N.Y. 1974) 383 F. Supp. 631 and *Simon v. Sunasco* (S.D.N.Y. 1970) CCH Fed. Sec.L.Rep. (1969-1970 Binder) ¶ 92,547, p. 98,509 (Foremost Br., pp. 23, 52). In *Makofsky*, stock was acquired and voted and, as Foremost correctly notes, "the potential for speculative abuse was found to exist when the defeated offeror had placed representatives on the Board of Directors" (Foremost Br., p. 52, ftn.). In *Simon*, there was an issue of "special stock," convertible into common stock, which had "equal voting rights with the common, i.e., each share, whether special or common, was entitled to one vote" (*Simon v. Sunasco* (S.D.N.Y. 1970) CCH Fed.Sec.L.Rep. (1969-1970 Binder) ¶ 92,547, p. 98,509).

any opportunity to obtain profits through speculation in Foremost stock.

When the undisputed facts show no access to inside information and no influence over corporate policy, we respectfully submit that it would be patently unreasonable to presume such access or such influence from mere ownership of unconverted debentures. The purposes of the Act would not be served by its application to such a transaction. Rather, as the district court aptly observed, application of § 16(b)'s "crude rule of thumb" to the facts of this case would be "application of an extremely crude rule of a most deformed and misshapen thumb" (Pet. Appx., p. 40a; 331 F.Supp. 792).

2. The court below erred in its conjecture that there was a potential for speculative abuse.

The Ninth Circuit's erroneous decision on the question of the potential for speculative abuse was influenced by its consideration of two factors:

> "(1) Could [Provident] reasonably be expected to have had access to inside information? And (2) did [Provident] initiate the transaction voluntarily?" (Pet. Appx., pp. 6a-7a; 506 F.2d 605).

The Ninth Circuit correctly noted that the presumption of access to inside information could be rebutted (Pet. Appx., p. 7a; 506 F.2d 605). However, it erroneously held that Provident had not rebutted that presumption simply because Provident had "not demonstrated that the Foremost management was hostile" (ibid.; see Foremost Br., p. 52), thus making management "hostility" a prerequisite to a *Kern County* defense. In *Kern County,*

however, this Court examined the facts to ascertain whether

> "* * * Occidental either had or was likely to have access to inside information, by reason of its ownership of more than 10% of the outstanding shares of Old Kern, so as to afford it an opportunity to reap speculative, short-swing profits * * *" (411 U.S. 596).

From the *fact*—among others—that Old Kern's management was hostile, this Court *inferred* that the likelihood of possession of inside information which would enable speculation was remote (411 U.S. 598). Plainly, if the presumption of access to inside information can be rebutted by such an inference, it can also be rebutted by other facts. As discussed above, the record is clear that Provident's brief ownership of the debentures did not give, nor was it likely to give, any access to inside information.

The Ninth Circuit also erroneously asserted that Provident, being aware that Foremost might need capital because of its purchase of Provident's assets, "might have had" access to information that Foremost had decided not to declare a dividend (Pet.Appx., p. 8a; 506 F.2d 606; and see Foremost Br., p. 52). By the same token, it is possible that Occidental "might have had" access to such information about Kern and, indeed, it is perhaps possible to engage in conjecture about the existence of such information in every transaction. But this Court has made it clear that the inquiry must be directed to the transaction which actually occurred. In *Kern County,* Occidental was an owner of stock and, unlike a debenture holder, had voting rights and, under California law, a

right to access to information not available to the general public, including a right to inspect the share register, the books of account, and the minutes of shareholders', board of directors' and executive committee meetings (Cal. Corp.Code § 3003). Moreover, Occidental was permitted access to Old Kern's general ledger, consolidated financial statements, consolidated journal entries, details of cash receipts from oil operations, supporting trial balances, and other records (411 U.S. 587, ftn. 12). From these facts, it would certainly be possible to theorize that Occidental "might have had" access to information which could have enabled it to speculate. The controlling consideration, however, was that Occidental did not have and was not likely to have access to such information. Again, the record is clear that Provident did not have access to any information at all, and was not in a position to obtain it, by reason of its ownership of the Foremost debentures.[20]

The Ninth Circuit's conclusion that the transaction was "voluntary" and that a "voluntary" transaction is neces-

[20]The Ninth Circuit also referred to the "general cooperation" in the negotiations leading up to Provident's purchase of Foremost's assets (Pet.Appx., p. 7a; 506 F.2d 605; and see Foremost Br., p. 52). As above noted (p. 38), that "cooperation" involved only a discussion of information about Provident. If the court below meant to suggest that friendly relations during the negotiations might have given access to information not otherwise available (which was not the case), such a suggestion is irrelevant:

> "The teaching of *Kern County* is that for Section 16(b) liability there must be a likelihood of access to inside information '*by reason* of its ownership of more than 10% of the outstanding shares', 411 U. S. at 596 (emphasis supplied), that is, 'by virtue of its stock ownership' 411 U. S. at 599. The otherwise casual acquisition of inside information through personal friendship and its use could be a violation of Section 10(b) and Rule 10b-5, but the irrebuttable presumption of § 16(b) should not be applied" (*American Standard, Inc. v. Crane Co.* (2 Cir. 1974) 510 F.2d 1043, 1055).

sarily subject to § 16(b) (Pet.Appx., pp. 7a-8a; 506 F.2d 605-606; and see Foremost Br., p. 50) was also in error. Provident's acquisition of the debentures was "voluntary" only in the sense that, at Foremost's insistence, it agreed to accommodate Foremost's financing. But Provident wished to receive only cash and had no desire whatever to receive the debentures. Indeed, as the district court noted,

> "In all its essential details the form of the transaction was insisted upon if not dictated by Foremost, often contrary to the plans and wishes of Provident. If the matter had been handled as Provident wished, this case could never have arisen" (Pet.Appx., pp. 40a-41a; 331 F.Supp. 792).

Moreover, we note again that the "voluntary" nature of the transaction is not controlling. In *Kern County*, involuntariness was again a *fact*—among others—involved in the stock conversion transaction. However, the subsequent stock option was a wholly voluntary transaction and this Court concluded that there existed no potential for speculative abuse in that transaction (411 U.S. 601-604). The voluntary nature of a transaction is simply not determinative (*Blau v. Lamb* (2 Cir. 1966) 363 F.2d 507, 520).

C. The application of § 16(b)'s conclusive presumption to the facts of this case would raise serious constitutional questions.

Application of § 16(b)'s conclusive presumption to the facts of this case would not only be contrary to this Court's opinion in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, but it would also raise serious

questions under the due process clause of the Fifth Amendment. Section 16(b) was enacted following extensive hearings in which evidence was received concerning speculation in stock by a class of insiders. As specified in § 16(b)'s introductory clause, the section was enacted

> "[f]or the purpose of preventing the unfair use of information which may have been obtained by [a statutory insider] * * * by reason of his relationship to the issuer" (15 U.S.C. § 78p(b), 48 Stat. 896).

The class of insiders consisted of "directors, officers, and principal stockholders of a corporation" (S.Rept. 792 (1934) 73rd Cong., 2d Sess., p. 9). As this Court has noted, these "[i]nsiders could exploit information not generally available to others to secure quick profits" *(Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 592). Accordingly,

> "* * * the only method Congress deemed effective to curb the evils of insider trading was a flat rule taking the profits out of a class of transactions in which the possibility of abuse was believed to be intolerably great" *(Reliance Electric Co. v. Emerson Electric Co.* (1972) 404 U.S. 418, 422).

Section 16(b)'s flat rule and its conclusive presumption of access to inside information have been previously held constitutional when applied to that class of insiders at which Congress aimed the statute—officers, directors and stockholders *(Gratz v. Claughton* (2 Cir. 1951) 187 F.2d 46, 49-50; *Park & Tilford v. Schulte* (2 Cir. 1947) 160 F.2d 984, 988; *Smolowe v. Delendo Corporation* (2 Cir. 1943) 136 F.2d 231, 239). Those holdings were all based on the fact that § 16(b) was enacted "upon a considered

finding, supported by ample evidence, of the abuses of inside speculation" *(Smolowe v. Delendo Corporation* (2 Cir. 1943) 136 F.2d 231, 239). However, as noted, that finding, and the evidence relating to it, concerned insiders who were officers, directors and stockholders.

As discussed above, although § 16(b) was clearly aimed at such insiders, the holders of convertible debentures were made potentially subject to it as a result of the definition of "equity security" as "any stock or similar security; or any security convertible * * * into such a security" (15 U.S.C. § 78c(a)(11)). Significantly, there is no finding and no evidence anywhere in the lengthy hearings which preceded the enactment of § 16(b), that owners of debentures would have access to inside information or that transactions by them are inherently subject to speculative abuse. The Second Circuit has taken express note of the nonexistence of any such finding and of evidence pertaining to the holders of debentures *(Chemical Fund, Inc. v. Xerox Corporation* (2 Cir. 1967) 377 F.2d 107, 110) and it has declared that

> "* * * there is no reason whatever to believe that any holder of any Convertible Debentures would, by reason of such holding, normally * * * be the recipient of any inside information" (377 F.2d 111).

A flat rule may be justified when there exists evidence of abuse inherent in a certain class of transactions. Indeed, this was the justification advanced for § 16(b). In a brief supporting the validity of § 16(b), Thomas Corcoran, one of the principal authors of the Act, made reference to the evidence regarding abuses in transactions "by

officers, directors and principal stockholders" and observed that this Court

> "* * * has upheld the power of the legislature to regulate or prohibit even acts which are in themselves innocent, *where control over them is necessary to the effective control of abuses*" (House Hearings, p. 937; emphasis added).

There is, however, no evidence and no reason to believe that holders of convertible debentures would have access to inside information and there is therefore no showing of any necessity of applying § 16(b) to transactions by them. In the absence of such a showing, we submit that application of the flat rule contained in § 16(b) would be contrary to the principle that:

> "Statutes creating permanent irrebuttable presumptions have long been disfavored under the Due Process Clauses of the Fifth and Fourteenth Amendments" *(Vlandis v. Kline* (1973) 412 U.S. 441, 446).

This is particularly so when there exist "other reasonable and practicable means of establishing the pertinent facts" (412 U.S. 451). Reasonable and practical means of seeking redress for actual abuse already exist in general remedies for fraud, stockholders' derivative actions, and other provisions of the Exchange Act, including § 10(b) and Rule 10b-5. Hence, in the absence of some evidence of wrong-doing, the application of § 16(b) to Provident's brief holding of the Foremost debentures, when Provident was never an officer, director or stockholder of Foremost, would raise serious questions under the due process clause of the Fifth Amendment.

III. PROVIDENT'S SALE OF THE DEBENTURES OCCURRED WHEN IT WAS NOT AN OWNER, DIRECTLY OR INDIRECTLY, OF 10% OR MORE OF FOREMOST'S COMMON STOCK.

The underwriting agreement through which one half of the Foremost debentures were sold by Provident was signed on October 21, 1969 (Jt.Appx., p. A82). It expressly provided that October 28 was to be the "time of purchase" by the underwriters from Provident and that Provident would deliver the debentures and receive payment at that time (Underwriting Agt., p. 1-2, following Jt.Appx., p. A134). Pursuant to that agreement, possession and the incidents of ownership were in fact transferred on October 28 (Jt.Appx., p. A82). Previously, on October 24, Provident had distributed to its shareholders the other one half of the Foremost debentures held by it (Jt.Appx., p. A82) so that, as the Ninth Circuit correctly noted,

> "* * * if the sale was not completed until October 28, the date of the closing and a date subsequent to the distribution of debentures to the shareholders, then Provident was not a beneficial owner of 10 percent at the time of sale, and Foremost cannot recover the profit" (Pet.Appx., p. 9a; 506 F.2d 606).

The question, then, is whether the sale by Provident was completed on October 21 or on October 28.

The Act itself broadly defines "sale" to "include any contract to sell or otherwise dispose of" (15 U.S.C. § 78c (a)(14)) but it includes no reference to the date of the sale. Accordingly, it is necessary to construe the language of the Act in the context of a particular transaction. In doing so, the terms "purchase" and "sale" must be con-

strued "in a manner which will effectuate the purpose of the specific section of the Act in which they are used" *(Bershad v. McDonough* (7 Cir. 1970) 428 F.2d 693, 696).

In determining the date of sale, courts have considered not only the date of a firm commitment to sell but also the date of the actual exchange, whether the rights of ownership are retained, and the date of the relinquishment of the incidents of ownership *(Champion Home Builders Co. v. Jeffress* (6 Cir. 1974) 490 F.2d 611, 616). In the instant case, Provident had ownership until October 28 and the actual exchange of debentures and the incidents of ownership took place on that date (Jt.Appx., p. A82). October 28 therefore is the date upon which the sale would ordinarily be deemed completed.

Both the court below and Foremost recognize that the date of the sale by Provident should be the date upon which the sale was completed (Pet.Appx., pp. 9a-11a; 506 F.2d 606-607; Foremost Br., p. 43). Foremost places great reliance on the Form 4 statement filed by Provident, erroneously asserting that the statement shows "the sale as of October 21, 1969" (Foremost Br., p. 11; and see ibid., p. 43). That form did not even purport to specify the date of the sale; it reported only a sale *"pursuant to* an Underwriting Agreement dated October 21, 1969" (Form 4 (following Jt.Appx., p. A54); emphasis added). As noted, the underwriting agreement itself defines October 28, 1969, as "the time of purchase" by the underwriters from Provident (i.e., the sale by Provident) and provided that Provident would deliver the debentures and receive payment at that time (Underwriting Agt. (following Jt. Appx., p. A134), pp. 1-2, par. 2).

The argument that the sale to the underwriters was complete on October 21 is also based upon the mistaken conclusion that Provident was "irrevocably bound" to sell and that it insulated itself against all market risks between October 21 and October 28 (Pet.Appx., pp. 10a-11a; 506 F. 2d 607). This conclusion by the court below is based upon an erroneous reading of the underwriting agreement. The court referred to paragraph 7 which permitted termination by the underwriters under certain conditions only until such time as the registration statement became effective. Because the statement became effective on October 21, the court mistakenly concluded that the agreement was not subject to termination by the underwriters after that date (Pet.Appx., p. 11a; 506 F.2d 607). In reaching that conclusion, the court totally overlooked the fact that, under paragraph 5(h), the agreement was subject to the additional express condition

> "That, between the time of execution of this agreement [October 21] and the time of purchase [October 28], there shall occur no material and unfavorable change, financial or otherwise (other than as referred to in the Registration Statement and the Prospectus), in the condition of the Company [Foremost] and its consolidated subsidiaries as a whole * * *" (Underwriting Agt. (following Jt.Appx., p. A134), p. 7, par. 5(h)).

The situation is therefore analogous to the stock option contract in *Kern County Land Co. v. Occidental Corp.* (1973) 411 U.S. 582, 601-602. The question there was whether the sale occurred on the date of the option agreement or the later date of its exercise. The later date was chosen because the option was not "an instrument with

potential for speculative abuse" (411 U.S. 602). This was so because Occidental had "no choice but to sell if Tenneco exercised the option" but Occidental gained no advantage "if the stock declined and Tenneco chose not to exercise its option" (ibid.).

Provident likewise could not have obtained speculative advantage through the underwriting agreement. Under it, Provident could not share in a rising market and, because the agreement was terminable under adverse conditions, it was not insulated from a falling one. There is therefore no reason to depart from the ordinary definition of the word "sale." Possession and ownership rights were not transferred until October 28 and that, accordingly, was the date upon which the sale was completed.

IV. THE TRANSACTION WAS EXEMPT FROM § 16(b) BECAUSE PROVIDENT ACTED AT ALL PERTINENT TIMES ON BEHALF OF ITS SHAREHOLDERS.[21]

A. Provident was a liquidating agent authorized by California law to administer the assets of its shareholders.

Section 16(b) does not cover "any transaction or transactions which the [Securities and Exchange] Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection" (15 U.S.C. § 78p

[21]There is no basis for Foremost's assertions that the courts below did not "accept" or that they "rejected" the arguments presented under this heading (see Foremost Br., pp. 12, 40). Having found the transaction exempt on other grounds, they did not pass upon these arguments.

(b)). One of the exemptions formulated by the Commission provides:

> "(a) During the period of 12 months following their appointment and qualification, securities held by the following persons shall be exempt from sections 16(a) and 16(b) of the act:
>
> • • • • •
>
> "(3) Receivers, trustees in bankruptcy, assignees for the benefit of creditors, conservators, liquidating agents, and other similar persons duly authorized by law to administer the estate or assets of other persons" (Rule 16a-4, 17 C.F.R. § 240.16a-4).

Provident was a liquidating agent or other similar person authorized by California law to administer the assets of its shareholders.

On September 26, 1969, the Provident shareholders approved a plan of complete liquidation under which Provident was to wind up its affairs and liquidate (Jt.Appx., pp. A78, A99-A101). That plan provided for pro rata liquidating distributions to the shareholders leading to the "complete liquidation of Provident" within a twelve-month period following adoption of the plan (Jt.Appx., pp. A102, A103). It was expressly provided that "all distributions made by Provident as such shall be made within the above-mentioned twelve-month period" (Jt. Appx., p. 104). And, as required by Rule 16a-4(a), all transactions complained of by Foremost took place within that twelve-month period and Provident was dissolved within that period (Jt.Appx., pp. A82-A83).

Under California law, the shareholders' approval of the plan of liquidation began the proceedings for the winding

up of Provident (Cal.Corp.Code, §§ 4600, 4604). As required by statute (Cal.Corp.Code, §§ 4603, 4605), a certificate of winding up was filed with the California Secretary of State (Jt.Appx., pp. A108-A110) and notice of winding up was sent to all shareholders and all creditors (Jt. Appx., p. A111). Under California law, Provident was under an express mandate to "cease to carry on business except to the extent necessary for the beneficial winding up thereof" (Cal.Corp.Code, § 4605). The California law also provides that:

> "After determining that all the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the directors shall distribute all the remaining corporate assets among the shareholders and owners of shares according to their respective rights and preferences" (Cal.Corp.Code, § 5000).

Thus, from September 26, 1969 forward, Provident existed for the sole purpose of liquidating and making distributions to its shareholders. The California law not only authorized but required the directors of Provident to act for its shareholders' benefit in the process of liquidation. In accord with this statutory mandate, the Foremost debentures were distributed pro rata as received and those portions of shares not distributed were held "as a separate fund for the sole benefit of the shareholders concerned pending sale or other appropriate disposition" (Jt.Appx., pp. A120-A121). Provident's officers considered that their "sole duty was to get the assets of Provident into the hands of its individual shareholders as quickly as possible" (Jt.Appx., p. A83).

Provident's status as a liquidating agent antedated both the date upon which the purchase agreement between Foremost and Provident became binding and the date of the receipt by Provident of the Foremost debentures. The purchase agreement was expressly conditioned upon approval by Provident's Board of Directors and shareholders (Jt.Appx., p. A76; Purchase Agt. (following Jt.Appx., p. A34), p. 14, par. 7(e)). That approval was given on September 26, 1969, after approval of the plan of liquidation (Jt.Appx., pp. A77-A78, A99-A101). No debentures were received until October 15 (Jt. Appx., p. A81).

Foremost asserts that the exemption provided by Rule 16a-4 was intended only to apply to estates of limited duration (Foremost Br., pp. 55-56). Even if such a requirement could be read into the rule, it is met here. The plan of dissolution adopted by Provident required complete distribution and dissolution within twelve months of September 26, 1969, and dissolution in fact occurred within that period (Jt.Appx., pp. A82-A83, A102-A107).

Foremost also places great store in the fact that there was no court supervision of the winding up and dissolution until August, 1970 (Foremost Br., pp. 55-56). Rule 16a-4 does not require court supervision. To the contrary, its only requirement is that persons doing the liquidating be "liquidating agents" or *"other similar persons"* who are "authorized by law" to so act. Under California law, after the shareholders have elected to wind up and dissolve, the directors of the corporation are "authorized by law," indeed commanded by law, to do

what is necessary to beneficially wind up and dissolve the corporation and to distribute the remaining assets to the shareholders (Cal.Corp.Code, § 5000). The directors continue to function as directors, but their scope of activity is severely limited. Once the election has been made, "the corporation shall cease to carry on business except to the extent necessary for the beneficial winding up thereof" (Cal.Corp.Code, § 4605). And the decision to wind up and dissolve can only be revoked by the shareholders (Cal.Corp.Code, § 4606) or, if the winding up process is under the supervision of the Court, by order of the Court (Cal.Corp.Code, § 4607). Without shareholder revocation, the corporation is irretrievably bound to dissolution and distribution and is acting only as a liquidating agent, or other similar person, to and for the benefit of the shareholders.

Foremost's assertion that "Rule 16a-4 was not designed to exempt arrangements by which a party could declare itself a 'liquidating agent,' engage in securities transactions, and then cause the liquidating agent status to be revoked" (Foremost Br., p. 57) is beside the point. In this particular transaction a bona fide election to liquidate and dissolve was made and carried out. If the hypothetical situation suggested by Foremost occurred, then the election to dissolve no doubt would be a sham and would be so treated.

There is likewise no basis for Foremost's assertion that Rule 16a-4 applies only to securities which have "devolved upon" a fiduciary (Foremost Br., p. 58). The rule clearly specifies that it applies to securities which

are "held" and it says nothing about the manner of their acquisition. Provident unquestionably did hold and sell the debentures within 12 months of the adoption of the plan of liquidation.

Here, Provident and its directors were acting as liquidating agents for Provident's shareholders. The acquisition of the Foremost debentures as payment for Provident's assets was an integral part of the plan of liquidation. The distribution of a part of those assets to the shareholders and the public sale of the remainder were expressly authorized and directed by the shareholders[22] and were within Provident's role as a liquidating agent. Accordingly, the transaction falls within the exemption from § 16(b) provided by Rule 16a-4.

B. Provident did not have beneficial ownership of the debentures at the time of the purchase and the sale.

1. Beneficial ownership at all times rested in Provident's shareholders, not in Provident itself.

Section 16(b) applies only to a "*beneficial* owner" of securities (15 U.S.C. § 78p(b); emphasis added). Prior to the acquisition of the Foremost debentures, Provident did not own any security of Foremost (Jt.Appx., p. A73). The debentures were acquired solely to accommodate Provident's liquidation and, we submit, beneficial ownership at all times rested in Provident's shareholders and not

[22]Approximately one half of the debentures were distributed pursuant to resolutions of the Board of Directors (Jt.Appx., p. A82). The sale of the other one half was undertaken with express authorization from the shareholders given prior to the sale by Provident (Jt.Appx., pp. A80-A81).

in Provident.[23] Hence, any transactions subject to § 16(b) would be transactions by the shareholders, not by Provident.

The facts pertaining to Provident's status as a liquidating agent for its shareholders are set forth above. To recapitulate briefly: The earliest possible date upon which it could have been determined that Provident had acquired the Foremost debentures is September 26, 1969 (supra, p. 55). Yet, the election to wind up and dissolve preceded that acquisition (Jt.Appx., pp. A77-A78, A95-A98, A99-A107). From the moment of the shareholders' adoption of the plan of liquidation and election to wind up and dissolve, Provident was committed either to distribute all assets to its shareholders or to sell the assets and distribute the proceeds to its shareholders (Cal.Corp.Code, §§ 4605, 5000; see discussion supra, pp. 54-57). Provident acquired the debentures in its capacity as an agent for its shareholders and all transactions by Provident in the debentures were for its shareholders and for its shareholders' benefit.

Thus, Provident never had a beneficial interest in the Foremost debentures. It was the shareholders who controlled the course of the liquidation and for whose benefit it was carried out. Accordingly, as of the time that the shareholders elected to wind up and dissolve Provident,

[23]Contrary to Foremost's arguments (Foremost Br., pp. 40, 45), Securities and Exchange Commission Forms 3 and 4, filed by Provident, do not establish beneficial ownership. As Professor Loss points out: "Failure to disclaim beneficial ownership does not, of course, establish liability under §16(b)" (Loss, Securities Regulation (Supp.2d Ed. 1969) Vol. V, p. 3062).

all beneficial interest in assets then owned or thereafter acquired rested in Provident's shareholders.

2. In any event, Provident was not a beneficial owner of 10% or more of a class of Foremost's securities at the time of sale.

Section 16(b) requires that a beneficial owner be such "both at the time of the purchase and sale" (Securities Exchange Act, § 16(b), 15 U.S.C. § 78p(b)). Assuming for purposes of argument that the date of the sale was October 21, 1969 (see discussion, supra, pp. 49-52) and that beneficial ownership of the debentures initially vested in Provident, Provident nonetheless was divested of such beneficial ownership prior to the signing of the underwriting agreement on October 21. On October 13, Provident's Board of Directors directed Provident's officers to distribute Foremost's debentures to the shareholders (Jt. Appx., pp. A79, A120-A121). The resolution expressly declared that the debentures would be distributed pro rata as received and that those portions of shares not distributed would be held "as a separate fund for the sole benefit of the shareholders concerned pending sale or other appropriate disposition" (Jt.Appx., pp. A120-A121).

The October 13 resolution did not fix a record or payment date (see Jt.Appx., pp. A118-A122). Under California law, when a date is not fixed in a resolution which declares a corporate dividend, the dividend vests in the shareholder as of the date of the resolution and the board of directors has no power to revoke the dividend (*Meyers v. El Tejon Oil & Refining Co.* (1946) 29 Cal.2d 184, 188, 174 P.2d 1, 3; *Smith v. Taecker* (1933) 133 Cal.App. 351, 352, 24 P.2d 182). Although this rule is generally applied

to dividends declared by a going corporation, it is equally applicable to the dividends declared by Provident. Provident could no more have stopped the liquidation and the distribution than a going corporation could revoke a declared dividend. Under the California law (Cal.Corp.Code, § 4606), the power of revocation rested in the shareholders, not Provident. The sale of the debentures was expressly authorized by the shareholders (Jt.Appx., pp. A80-A81) and Provident acted as a liquidating agent in carrying out the sale (see discussion, pp. 52-57). The proceeds of the sale were thereafter distributed to the shareholders (Jt.Appx., pp. A82-A83).

It is simply not true that Provident "repudiated" the October 13 resolution and "never carried it out" (Foremost Br., p. 46). Approximately one half of the debentures were distributed to the shareholders. The sale of the other one half, and the distribution of the proceeds in accord with the October 13 resolution, was undertaken with express authorization from the shareholders given prior to the sale (Jt.Appx., pp. A80-A81). There is also no significance to the fact that there may have been liquidating preferences and creditors to be paid (see Foremost Br., p. 47). Such conditions merely state the terms and extent of the shareholders' beneficial ownership. One's vested right in a fund may be subject to prior satisfaction of some other person's rights.

Therefore, even if beneficial ownership initially vested in Provident, that ownership was divested on October 13, 1969. Hence, even if the sale is deemed to have occurred on October 21, Provident was not a beneficial owner at that time and section 16(b) is not applicable.

CONCLUSION

For each of the foregoing reasons, we respectfully submit that the judgment should be affirmed.

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(Appendix Follows)

Appendix

SECURITIES EXCHANGE ACT OF 1934

Section 3(a) (15 U.S.C. § 78c(a)):

"(a) When used in this chapter, unless the context otherwise requires—

* * * * *

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profitsharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

"(11) The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

* * * * *

"(13) The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire.

"(14) The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of" (48 Stat. 882).

Section 10(b) (15 U.S.C. § 78j(b)):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" (48 Stat. 891).

Section 16 (15 U.S.C. § 78p):

"(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 [15 U.S.C. § 78*l*] of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 12(g) [15 U.S.C. § 78*l*(g)] of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange,

also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where

such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

"(c) It shall be unlawful for any such beneficial owner, director, or officer, directly or indirectly, to sell any equity security of such issuer (other than an exempted security), if the person selling the security or his principal (1) does not own the security sold, or (2) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation; but no person shall be deemed to have violated this subsection if he proves that notwithstanding the exercise of good faith he was unable to make such delivery or deposit within such time, or that to do so would cause undue inconvenience or expense.

"(d) The provisions of subsection (b) of this section shall not apply to any purchase and sale, or sale and purchase, and the provisions of subsection (c) of this section shall not apply to any sale, of an equity security not then or theretofore held by him in an investment account, by a dealer in the ordinary course of his business and incident to the establishment or maintenance by him of a primary or secondary market (otherwise than on a national securities exchange or an exchange exempted from registration under section 5 [15 U.S.C. § 78e] of this title) for such security. The Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, define and prescribe terms and

conditions with respect to securities held in an investment account and transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market.

"(e) The provisions of this section shall not apply to foreign or domestic arbitrage transactions unless made in contravention of such rules and regulations as the Commission may adopt in order to carry out the purposes of this section" (48 Stat. 896; 78 Stat. 579).

FEDERAL REGULATIONS

Securities and Exchange Commission Rule 10b-5 (17 C.F.R. § 240.10b-5):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

§ 3003:

"The share register or duplicate share register, the books of account, and minutes of proceedings of the shareholders and the board of directors and of executive committees of the directors of every domestic corporation and of foreign corporations keeping any such records in this State shall be open to inspection upon the written demand of any shareholder or holder of a voting trust certificate at any reasonable time, for a purpose reasonably related to his interests as a shareholder or as the holder of such voting trust certificate, and shall be exhibited at any time when required by the demand at any shareholders' meeting of 10 percent of the shares represented at the meeting.

"Such inspection by a shareholder or holder of a voting trust certificate may be made in person or by agent or attorney, and the right of inspection includes the right to make extracts. The right of the shareholders to inspect the corporate records may not be limited in the articles or by-laws.

"Demand of inspection other than at a shareholders' meeting shall be made in writing upon the president, secretary, assistant secretary, or general manager of the corporation."

§ 4600:

"Any corporation may elect to wind up its affairs and voluntarily dissolve by the vote or written consent of shareholders or members representing 50 percent or more of the voting power."

§ 4603:

"Whenever a corporation has elected to wind up and dissolve a certificate evidencing such election shall be

forthwith filed in the office of the Secretary of State and a copy thereof, certified by the Secretary of State, shall be filed in the office of the county clerk of the county in which the principal office of the corporation is located.

"The certificate shall be signed by the president or vice president and the secretary or assistant secretary, or by at least a majority of the directors, or by one or more shareholders or members authorized to do so by shareholders or members holding or representing at least 50 percent of the voting power, and verified by their affidavit stating, in effect, that the matters set forth in the certificate are true of their own knowledge, and shall set forth:

"(a) That the corporation has elected to wind up and dissolve.

"(b) If the election was made by the vote or written consent of shareholders or members, the number of shares or memberships voting for or consenting to the election and the total number of outstanding shares or memberships the holders of which were entitled to vote on or consent to the election.

"(c) If the certificate be executed by shareholders or members as such, that the subscribing shareholders or members were authorized to execute the certificate by shareholders or members holding or representing 50 percent or more of the voting power.

"(d) If the election to dissolve was made by the board of directors pursuant to Section 4601, the certificate shall also set forth the vote by which the election was made and the circumstances showing the corporation to be within one of the categories described in said Section 4601."

§ 4604:

"Voluntary proceedings for winding up the corporation are deemed to commence upon the adoption of the resolution of shareholders or directors of the corporation electing to wind up and dissolve, or upon the filing with the corporation of the written consent of shareholders thereto. However, if such proceedings are instituted because of the expiration of the term of corporate existence or other dissolution of the corporation, the proceedings for winding up are deemed to commence at the date of termination of its corporate existence."

§ 4605:

"When a voluntary proceeding for winding up has commenced, the corporation shall cease to carry on business except to the extent necessary for the beneficial winding up thereof, and except during such period as the board of directors may deem necessary to preserve the corporation's good will or going-concern value pending a sale of its business or assets, or both, in whole or in part. The directors forthwith shall cause written notice of the commencement of the proceeding for voluntary winding up to be given by mail to all shareholders and to all known creditors and claimants whose addresses appear on the records of the corporation."

§ 4606:

"A voluntary election to wind up and dissolve may be revoked prior to distribution of any assets by the vote or written consent of shareholders or members representing no less than a majority of the voting power, or by resolution of the board of directors if the election was by the directors pursuant to Section

4601. Thereupon, a certificate evidencing the revocation shall be subscribed, verified and filed in the manner prescribed by Section 4603.

"The certificate shall set forth:

"(a) That the corporation has revoked its election to wind up and dissolve.

"(b) That no assets have been distributed pursuant to the election.

"(c) If the revocation was made by the vote or written consent of shareholders or members, the number of shares or memberships voting for or consenting to the revocation and the total number of outstanding shares or memberships the holders of which were entitled to vote on or consent to the revocation.

"(d) If the election and revocation was by resolution of the board of directors it shall be so stated."

§ 4607:

"If a corporation is in the process of voluntary winding up, the superior court of the county in which the principal office of the corporation is located, upon the petition of (a) the corporation, or (b) the holders of 5 percent or more of the number of its outstanding shares, or of (c) three or more creditors, or of (d) three or more persons who have purchased homes from a construction corporation, and upon such notice to the corporation and to other persons interested in the corporation as shareholders or creditors as the court may order, may make orders and adjudge as to any and all matters concerning the winding up of the affairs of the corporation.

"If the corporation has, within 18 months prior to the commencement of the proceedings for winding up, been engaged in the business of constructing, or con-

tracting or subcontracting for the construction of buildings for residential use, the court shall, in making orders and adjudging as to matters concerning the winding up, make such provision as it deems reasonably necessary to protect the rights of the purchasers of the homes, including rights which may arise against the corporation for breach of warranties in connection with the construction. The protection so afforded shall extend to rights which may arise with respect to buildings whose construction was completed within 18 months prior to the commencement of the proceedings for winding up, and the orders and decrees extending the protection shall have a duration of at least 18 months after the filing of the petition but may be made effective for a longer period at the discretion of the court."

§ 5000:

"After determining that all the known debts and liabilities of a corporation in the process of winding up have been paid or adequately provided for, the directors shall distribute all the remaining corporate assets among the shareholders and owners of shares according to their respective rights and preferences. If the winding up is by court proceeding or subject to court supervision, the distribution shall not be made until after the expiration of any period for the presentation of claims which has been prescribed by order of court."